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IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1932

Petroleum Exploration, Inc., *Petitioner,* *vs.* David Burnet, Commissioner of Internal Revenue,	No. 448.
United States, *Petitioner,* *vs.* Dakota-Montana Oil Company.	No. 434.

BRIEF OF MESSRS. THOMAS R. DEMPSEY AND A. CALDER MACKAY AS AMICI CURIAE,

Consent of counsel having been obtained.

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PRELIMINARY STATEMENT.

The question presented by this appeal is involved in numerous pending cases and may be briefly stated to be:

ARE CAPITALIZED EXPENDITURES FOR WAGES, FUEL, REPAIRS, HAULING, ET CETERA, MADE IN CONNECTION WITH THE DEVELOPMENT OF OIL PROPERTIES AND THE DRILLING OF OIL WELLS, SUBJECT TO AN ALLOWANCE FOR DEPRECIATION?

Under the Regulations of the Treasury Department taxpayers are permitted the option of capitalizing or charging to expenses such expenditures as are paid for wages, fuel, repairs, hauling, *et cetera*, in connection with the development of oil properties and the drilling of oil wells. The Regulations specifically provided that "If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation." (Article 223, Regulations 62.)

The Commissioner has limited the application of this provision from the Regulation to tangible assets which go upon the property, such as lumber, cement, casing, tubing, *et cetera*, and excludes the costs expended: (1) for labor in making improvements, (2) in drilling the well, (3) for fuel used in such operation, (4) for hauling such materials, (5) for building pipe lines, (6) for roads, *et cetera*, and (7) for repairs.

It is believed that the Commissioner has erroneously construed his own Regulations, but if not, then we respectfully urge that the Regulations are in conflict with the provisions of the Statute which allow improvements to be depreciated.

The Board of Tax Appeals has in several cases held that taxpayers are entitled to the depreciation allowances claimed (*A. T. Jergins Trust v. Commissioner*, 22 B. T. A. 551; *Petroleum Exploration v. Commissioner*, 23 B. T. A. 890; *Albert W. Ziegler v. Commissioner*, 23 B. T. A. 1091; *P- M- K Petroleum Co. v. Commissioner*, 24 B. T. A. 360) while some of the courts have held otherwise.

This brief is filed in support of the decisions of the United States Board of Tax Appeals holding that taxpayers are, under the Statute, permitted to take the deductions claimed.

STATUTES AND REGULATIONS INVOLVED.

These are set forth in the appendix, *infra*, p. 17.

The Statutes have specifically allowed a deduction for depreciation, and in determining the cost of depreciable property it has been the consistent policy of taxpayers as well as the consistent policy of the Treasury Department to include in the cost thereof amounts expended for labor, fuel, transportation, *et cetera*. Indeed, it would never occur to the ordinary mind that these expenditures could be excluded. To exclude them would be to permit them to be deducted as ordinary expenses. The business world uniformly includes in the cost of buildings such expenditures as are made for labor, fuel, transportation, *et cetera*, in connection with the construction thereof. The Commissioner recognizes these principles insofar as they apply to improvements not related to oil properties.

The statutory provisions relating to an allowance for depreciation of improvements made and used in connection with oil properties are practically the same as the provisions allowing depreciation deductions generally; they are both intended to return to the taxpayer its actual cost of its property.

The section of the Statute under which the deductions for depreciation are claimed is Section 214 (a), which provides:

"In computing net income there shall be allowed as deductions:

"(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; * * *."

The mere fact that the allowance for depletion and depreciation are contained in the same section should be no reason for the Commissioner to allow depletion against expenditures made for the construction or acquisition of improvements or betterments. Both depreciation and depletion have a well understood meaning. This Honorable Court has stated that:

> "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used."

While

> "The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. * * *"
>
> *U. S. v. Ludey*, 274 U. S. 295, 300, 302.

We respectfully submit that oil wells and improvements connected therewith are a part of the plant used in production and not a part of the deposit; obviously, the reduction in value of an oil well due to wear and tear

through use is something apart from the reduction in value of the mineral reserve through removal of the product. The word "depletion" is derived from the Latin word "deplere" meaning to empty or exhaust, while the word "depreciation" is derived from the word "depretiare" meaning to lessen in value.

Congress recognized the difference in the passage of the foregoing Act. The legislative history clearly and convincingly proves that Congress not only recognized the difference between depletion and depreciation, but clearly intended that a depreciation allowance should be made for the exhaustion of improvements made and used in connection with the development of oil properties and the production of minerals therefrom. The section of the law controlling the case at bar was first inserted in the Revenue Act of 1918, and has repeatedly been re-enacted. The Report of the Ways and Means Committee of the House of Representatives (H. R. Report 767, 65th Congress 2nd Session) contained the following:

> "The depletion provision of the existing law does not grant an allowance for cost of development. In the case of mines, oil and gas wells such an allowance seems only equitable and fair and the bill provides that a reasonable allowance in such cases be allowed for *depreciation of improvements.*" (Italics ours.)

It is clear from the foregoing that Congress intended the cost of development to be returned to taxpayer through depreciation allowances and not through depletion allowances. It is believed that no clearer language could have been used to have expressed such an intention.

After the enactment of the Revenue Act of 1918 the Treasury Department promulgated its Regulation which in part (Art. 223) provided as follows:

> "Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion."

The Board of Tax Appeals (*Old Farmers Oil Company,* 12 B. T. A. 203) stated:

> "The Revenue Act of 1918 conferred no authority on the Commissioner to arbitrarily determine by regulation or otherwise that a purely capital item was a business expense."

The Commissioner acquiesced in the Board's decision (C. B. VII-2 p. 30). Irrespective of the option, however, the Regulation, had it contained no provision other than the excerpt above quoted, would have been invalid inasmuch as it ignored the provision of the law making an allowance for "depreciation of improvements." But the Regulation did not stop with the above quoted provision, it contained the following:

> "If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation."

In the case before this Court the Commissioner has refused to follow the plain and ordinary meaning of the

Treasury Department's Regulation and is attempting to endow them with a meaning not susceptible thereunder. The true meaning of the Regulation is clear. When read in conjunction with the Statute the Regulation simply states that a depreciation allowance will be made with respect to all incidental expenses incurred in the exploration and development of an oil property provided that the expenditures are made in connection with improvements of a physical nature. The Commissioner, however, has taken the position that the term "physical property" as used in the Regulation has a very limited meaning.

The Statute allows a depreciation deduction with respect to improvements regardless of the nature, and the Regulation expressly provides for just such an allowance. However, the Commissioner is attempting to so construe the Regulation as to achieve a result which is not justified by the Statute or by the plain meaning of the Regulation.

It is respectfully submitted that the Court's approval of the Commissioner's construction of the Regulation would be tantamount to simply striking from the Statute the words "and for depreciation of improvements," for the very simple reason that the total cost of the improvements is not taken into consideration in determining the depreciation allowance. The Regulation, when read in conjunction with the section of the Statute under which it was promulgated, obviously requires that such of these expenses as are incurred in connection with the acquisition of physical property—improvements—must be returned through depreciation. All other of such expenses are re-

turnable through depletion. An illustration of the expenses returnable through depletion is the cost of a geological survey, resulting in no improvement of physical property, and which represents the cost of acquiring or locating the oil deposit.

The construction of the Regulation herein contended for brings it in harmony with the Statute while the Commissioner's construction thereof creates a direct conflict with the Statute. A construction of the Regulation that conforms to the requirements of the law is to be preferred to a construction resulting in a conflict. This would be so irrespective of how long the Regulation has been in effect or whether the Regulation has had legislative approval. It is not within the sphere of the Commissioner to alter or amend the law. He may not supply the omissions of Congress nor delete such provisions as are contrary to his conception of reasonableness or propriety. It is his duty to administer the law as he finds it.

Even though the Commissioner contends that the Regulation has had legislative approval, it cannot be successfully contended that his interpretation of the Regulation has been clothed with equal dignity. If Congress placed its approval upon the Regulation by subsequent reenactments, it must be presumed to have interpreted it according to the plain meaning of its terms and in the light of the law itself. Certainly Congress cannot be charged with an interpretation by the Commissioner of the Treasury Department's Regulation which is contrary to its plain terms. Prior to the passage of the 1932 Act the Board of Tax Appeals had, in the four cases heretofore cited, determined that the Commissioner's in-

terpretation was erroneous; there had been no decision prior to the passage of the 1932 Act which upheld the Commissioner's interpretation. If the Regulation has received approval by Congress it has been the approval of the interpretation herein contended for and as approved by the United States Board of Tax Appeals.

We believe the United States Board of Tax Appeals was right when, in the Jergins case, 22 B. T. A. 551, it stated:

> "The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It cannot be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves. * * *."
>
> "* * * The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.'"

It is a significant fact that the Commissioner before the United States Board of Tax Appeals in the Jergins case recognized the legality of this statement, which is evidenced by the following excerpt from the Board's opinion:

> "The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amounts disallowed were represented by physical property. * * *"

However, the Commissioner in his brief, at page 36, before the United States Circuit Court of Appeals for the 9th Circuit in the case of *A. T. Jergins Trust v. Commissioner of Internal Revenue*, refused this recognition and gave his interpretation of the article in the following language:

> "These articles of the regulations undertake to distinguish between expenditures for physical property subject to depreciation and expenses incurred in exploration, drilling, and development, which do not result in any tangible physical property apart from the land itself. There is an appropriate factual basis for this classification. 'Physical property' as used in the regulations, as shown by the classes of property specifically mentioned as illustrations, refers to articles of property which have measurable service lives depending upon their own inherent qualities and the extent of their use in the enterprise. These factors determine the rates at which such property is consumed. The amount of its annual depreciation is ascertainable under the general principles and by the usual methods for determining allowances for depreciable property used up in business. On the other hand, money spent in exploring for oil, for development (such, for example, as clearing the surface of the land), the digging of the hole in the ground through which the oil is extracted, does not result in any article of property apart from the land. It does result in changes in the conformation of the land, and may be regarded as providing facilities for access to and extraction of the mineral, but there is no gradual wearing out or using up of such facilities. They are, of course, no longer useful when all of the mineral has been extracted, but their usefulness is associated with and measured by the quantity of the mineral.

> Such facilities are similar to shafts, tunnels, slopes, stripping, etc., in the case of a coal mine which are made while the mine is in the development stage, the cost of which is likewise recoverable through depletion allowances. Article 222, Regulations 62."

The above construction of the Regulation completely ignores the provision of the Statute permitting a depreciation deduction with respect to *improvements*. It may be assumed that certain "improvements" such as grading, roads and the drill hole "do not result in any tangible physical property apart from the land itself." It is equally obvious that such improvements have "service lives" *not* depending upon their own inherent "qualities." Their service lives depend solely upon the life of the mineral reserve itself. They are useful in an oil property just so long as it produces oil. After the property is exhausted they are utterly worthless for the purpose for which originally constructed. It may even be assumed that with reasonable repair, the cost of which is deductible as an expense, such improvements would last forever. But Congress, in providing for a depreciation deduction with respect to improvements, had in mind that any improvement put upon a property for the purpose of development and operation has a useful life no longer in any case than the life of the deposit itself. This was the obvious reason for permitting the deduction for depreciation of improvements. The drill hole of an oil well is a part of the well itself. In addition to the drill hole a completed oil well has a large number of other parts, for instance, casing which keeps the hole from caving in, the derrick, boiler plant, engines, pumps, etc. All these things are necessary to make an oil well. An oil well is an

improvement. Under the Commissioner's interpretation the drill hole is something separate and apart from the oil well itself and is not an "improvement" for the reason that the drilling of the hole does not "result in any tangible physical property apart from the land itself."

As above indicated, it may be assumed *arguendo* that the drill hole by itself is not an improvement but when casing has been installed in it and other things necessary to make a completed oil well, then the hole constitutes a part of an improvement. The cost of drilling the hole is, therefore, a part of the cost of the completed improvement.

To say that the parts of an oil well other than the drill hole "have measurable service lives depending upon their own inherent qualities" is totally beside the point. Aside from ordinary repairs necessary in any improvement the several parts of an oil well will last, stated as a general rule, until the oil deposit is exhausted. Except in very unusual cases the casing in the hole will last as long as oil can be produced through it. When the deposit is exhausted some of the casing may be pulled out of the hole and salvaged, but very few oil men ever use it in another oil well. The fact that the salvage may be recovered from an oil well does not require any changes in the usual computation of depreciation thereon because salvage is usually recovered from every fixture. For instance, when buildings are torn down salvage is recovered but the Regulations generally provide that in making computation of the capital returnable through depreciation allowance must be made for salvage.

The Commissioner admits that improvements "which do not result in any tangible physical property apart from

the land itself" are "no longer useful when all the mineral has been extracted" but he further contends "their usefulness is associated with and measured by the quantity of the mineral." That their usefulness must be measured by the quantity of the mineral is, of course, undeniable. This is likewise true with respect to certain items which the Commissioner terms physical property in his construction of the Regulation. The depreciation on the cost of an oil well other than the drill hole is determined by the Commissioner by reference to production. By this method the cost of the well except the cost of the drill hole is depreciated over the life of the mineral deposit. This is in recognition of the fact that "their usefulness is associated with and measured by the quantity of the mineral." From these considerations it is apparent that the Commissioner's construction of his Regulation is not only totally lacking in "an appropriate factual basis for this classification" but wholly disregards the Act under which the Regulation was promulgated.

It is significant that Congress in framing Sec. 234(a)(8) of the Revenue Act of 1924 and corresponding sections in the Revenue Acts, used the word "improvements" and in Section 234(a)(7) and corresponding sections of other Revenue Acts the term "property" was used. A road, a sump hole, a cellar or a drill hole is not "property" but is an "improvement" or part of an improvement. The cost of each is, therefore, subject to depreciation if it has a measurable service life.

The United States Board of Tax Appeals in the Jergins case aptly stated that the "amounts expended in development and drilling operations convey to us the

impression of expenditures for improvement of the property upon which the Statute permits the taxpayer to deduct depreciation." We, therefore, respectfully submit that taxpayers are entitled, under the Statute, to depreciation deductions based on the full cost of their improvements.

Respectfully submitted,

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APPENDIX.

REVENUE ACT OF 1926:

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

"Sec. 204(c) (2). In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

TREASURY REGULATIONS 69 provide:

"Art. 221. Depletion in the Case of Oil and Gas Wells.—Under section 204(c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount

equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204(c) (2) and this article, refers to the separate tracts or leases of the taxpayer."

"Art. 223. Charges to Capital and to Expense in the Case of Oil and Gas Wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *."

"Art. 225. Depreciation of Improvements in the Case of Oil and Gas Wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably dis-

tributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161-170.)"